> a competitive firm must pay to acquire its intangible as well as tangible capital . . . . [T]he Commission's tentative decision to exclude from the rate base all intangible capital acquired through purchase is inconsistent with the objective of setting prices that reflect the costs of competitive systems.

Woodbury and Besen at 26-27.

While the general rule against ratebase treatment of "excess" acquisition costs ostensibly comes from the Commission's telephone ratemaking experience, that history is itself far too complicated and complex to support so simplistic an approach. In its telephone company regulation, the Commission has utilized different rules for differing circumstances in its treatment of acquired plant, depending upon such factors as whether the acquired plant was carrying traffic or not, whether the purchase price was below a nominal amount, or whether the acquisition was made from an affiliate. In the last case, the FCC has decided that plant not carrying traffic and acquired from a non-affiliate is presumptively entitled to ratebase treatment.[14]

The costs of other telephone company acquisitions, for plant carrying traffic or any plant acquired from affiliates, are permitted in the ratebase upon a showing by the carrier that such inclusion is reasonable. This case-by-case treatment was

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[14] See Decision on Remand in CC Docket No. 86-497, 7 FCC Rcd 296 (1991). The Commission's decision was in large part driven by the Court of Appeals' remand of an appeal taken from the Commission's initial decision to presumptively exclude such acquisition costs. See Illinois Bell Telephone Co. v. FCC, 911 F.2d 776 (D.C. Cir. 1990).

explicitly described by the Commission as a longstanding ratemaking policy:

> We have always placed on the carrier the responsibility of justifying the inclusion of amounts claimed for plant acquisition adjustments. This requirement has not been modified or reversed by later Commission orders. . . . [W]e continue to believe that inclusion of such amounts must be determined on a case-by-case basis and require the acquiring carrier to demonstrate that the price paid for the property accurately reflects its value to the ratepayers or is otherwise in the public interest.

Ratebase Reconsideration Order, 4 FCC Rcd 1697, 1704 (1989), aff'd sub nom., Illinois Bell Telephone Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993).

Notwithstanding complaints that case-by-case treatment of acquisition cost inclusion is "burdensome," "imposes costs on ratepayers," and may result in inefficient plant decisions, the Commission insisted that inclusion decisions can be made solely on individual showings. The inability of the FCC to articulate in advance the specific criteria that would appropriately be applied to such showings was fully recognized:

> While parties ask that we develop specific criteria for approval of plant acquisition adjustments, we believe that the nature of the acquisitions and the circumstances under which they take place are highly diverse and specific criteria can not be developed for all situations.

Ratebase Reconsideration Order, 4 FCC Rcd at 1705 (emphasis supplied). The Commission cited as just one example an acquisition made as part of a "program of integration justified in the public interest for the purpose of achieving operating efficiencies that result in cost savings which offset any unavoidable excess in acquisition costs over original costs." Id. at n. 40.

Further, the Commission recognized the need for a transitional rule. The Commission thus grandfathered the inclusion in the ratebase of such acquisition costs for such carriers, and applied the rule prospectively. Id. at 1705. A similar transitional rule is in order here.

The Notice already recognizes that not all of the "excess" acquisition costs are necessarily monopoly rents. Notice at ¶ 38 and n. 40. Much of the "excess" is appropriately attributed to numerous intangibles that are traditionally recoverable in a rate-of-return regulatory model. Some "excess" may also reflect the necessary recovery of accumulated losses by the seller.[15] Moreover, because investment decisions by cable operators have been made free of any regulatory distortions, they are presumptively efficiency-producing -- in marked contrast to regulated telephone companies.[16]

TCI's growth over the last 10 years has derived from new construction into unserved areas, increased penetration for systems already owned by TCI and by acquisition of existing

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15 The appropriate treatment of accumulated losses as ratebase items is discussed in full in Section II.C., infra.

16 The FCC rules limiting the inclusion of acquired plant for telephone companies are in fact based upon concerns that the carriers have the incentive to "manipulate" acquisition prices to "inflate" the ratebase. Ratebase Order, CC Docket No. 86-497, 3 FCC Rcd 269, 273 (1987).

systems.[17] The acquisitions have been made for a variety of reasons. Some of the cable systems acquired were part of a clustering strategy, common among MSOs, to capture the benefits of operating efficiencies (e.g., through sharing of personnel and/or equipment) of serving contiguous communities. Some were made where TCI perceived that because of its experience, expertise, and size it could operate those systems more efficiently. A common thread connects all of these reasons: TCI purchased assets which it believed would be more valuable under its management and operation than they were under the then current owners'. This greater value is reflected in the purchase price paid for the assets.[18]

Under any administrative interpretation, such acquisitions represent "prudent investments" in assets used to provide regulated cable services to subscribers.[19] No sound

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[17] By way of example, the number of subscribers that TCI serves increased from 1.9 million in 1983 to 10.5 million in 1993.

[18] The Notice appears to suggest that "this is not likely to be the case where competition does not exist." Notice at ¶ 36. If by this the Notice is opining that monopolists have no incentive to engage in transactions that increase efficiency, it defies well-established economic learning. See, e.g., F. M. Scherer, "Industrial Market Structure and Economic Performance" (2d ed. 1980). Only where regulatory distortions prompt a regulated monopolist to act inefficiently is this a concern. If on the other hand it means that the monopolist will be able to capture all additional profits, this consequence is ostensibly the point to rate regulating in the first instance.

[19] A policy of disallowance would not only penalize cable companies for being more efficient, it would perversely act in the future as a disincentive to operators to undertake efficiency-producing transactions. By way of analogy, it is (continued...)

ratemaking principle would allow the Commission to categorically dismiss these investments as exclusively comprising the expectation of monopoly rents. The Commission has consistently presided over mergers and acquisitions in industries within its jurisdiction, and has approved such consolidation as being in the public interest. Horizontal integration, at least until it results in concentration tending toward market power, has been repeatedly lauded by the FCC as efficiency-producing. FCC Report on Competition and Rate Deregulation in Cable Television Service, CC Docket No. 89-600, 5 FCC Rcd 4962, 5003-5006 (1990). Indeed, some of the very largest consolidations within the cable industry have been achieved only after the required public interest finding was issued by this Commission. See, e.g., Storer, 59 Rad. Reg. 2d 611 (1985); Time Warner Merger, 4 FCC Rcd 4707 (1989); Group W Acquisition, 4 FCC Rcd 8343 (1989).[20] Having made these findings, the agency cannot now reverse course, without any record basis, and rule, either categorically or even presumptively, that all such acquisitions were "imprudent." Compare Notice with Ratebase Order, 3 FCC Rcd 269, 273 (costs of

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[19](...continued) well-established that regulatory policies of the 1980s in the energy field which disallowed investments made by electric companies in nuclear power plants may well lead to severe electricity shortages in the 1990s. See, e.g., "Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?," 77 Geo. L. J. 2031 (1989); Navarro, Peter, The Dimming of America: The Real Costs of Electric Utility Regulatory Failure, ch. xxiv (1985).

[20] Many acquisitions were also approved by local franchise authorities since they involved transfers of the relevant franchises.

mergers approved under Section 221(a) procedures allowed in ratebase).

B. Accumulated Losses Should Be Given Ratebase Treatment.

The Commission suggests allowing cable operators to include in the ratebase accumulated losses incurred in the provision of regulated service. Notice at n. 44. TCI fully supports this view. As the Commission noted, "large financial losses are common across the industry." Id. TCI, in fact, has historically experienced initial losses from its cable operations, with these losses being recouped only after a system matures.

In the early years of a system's operation, the full cost of providing cable service is not charged to subscribers, since that would discourage subscribers from taking service. Indeed, it is probably not possible to charge early subscribers prices that are sufficient to cover costs. TCI keeps its prices low in the hope of attracting sufficient additional subscribers to eventually show profits that justify the initial losses. Those losses reflect an investment made by the company. If the Commission were to disallow recovery of these losses in the ratebase, TCI would be unfairly deprived of a return on its investment. Moreover, undertaking future investments that yield similar losses would be discouraged.[21]

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[21] These losses have not been recorded as an asset of TCI but, rather, have been expensed in the income statement of the period. These accumulated losses are therefore not captured on (continued...)

The Commission should follow the other regulators, which allow regulated industries, such as electric utilities, to defer these costs for future recovery, rather than requiring them to expense these items in the current period. Attached to this document is a summary of Statements of Financial Accounting Standards Nos. 71 and 92, which explain this treatment.

C. The Commission Cannot Prescribe Depreciation Rates At This Time.

The Commission proposes to prescribe depreciation rates for purposes of developing cost-based rates for regulated cable services. Several options, including the use of industry-wide depreciation rates, bands of reasonable rates, or individual rates for each plant category, are presented. Additionally, the Commission discusses the possibility of requiring cable operators to use company-wide depreciation expense as reported in SEC financial statements or linking depreciation to the specific circumstances in each franchise.[22] As an alternative to prescribing depreciation rates, the Commission asks whether it should monitor cable depreciation practices. Such an approach, as the Commission notes, could reduce administrative burdens on itself and cable operators.[23]

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[21] (...continued)
TCI's books and records but could be estimated as part of a cost-of-service proceeding for inclusion in the rate-setting process.

[22] Notice at ¶ 27.

[23] Id. at ¶ 29. TCI computes depreciation on a straight-line basis using estimated useful lives of 5 to 15 years for distribution systems and 3 to 40 years for support equipment and buildings. TCI 1992 Form 10-K.

As the Commission has repeatedly recognized, reliance on erroneous depreciation measures can result in misleading financial pictures and, in turn, lead to inaccurate investment and regulatory decisions. See, e.g., Depreciation Order, 83 FCC Rcd 267, 271 (1980). The inexact nature of depreciation accounting is itself problematic. This problem is critically complicated by the fact the Commission does not have nor will have sufficient information based on this record to prescribe depreciation rates in this proceeding. And too much is at stake to simply guess at the answers:

> One of the most difficult and interesting problems of ratemaking in the face of cost changes over time has to do with the appropriate reflection of technological change in determining the depreciation component of cost of service. In view of the immense importance of technological progress for economic welfare it becomes especially important to see to it that cost-of-service determinations are compatible with the optimum adoption of new technology.

A. Kahn, The Economics of Regulation: Principles and Institutions at 117 (1970).

As the Commission correctly observes in this proceeding and in its Orders represcribing depreciation rates for telephone companies, depreciation requirements can significantly affect the regulated industry.[24] Yet, depreciation accounting is inherently an uncertain exercise, involving a high degree of estimation of various factors including, among other things, service lives and

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[24] Notice ¶ 26; Proceedings to Allocate Depreciation Reserve, As Required by the Final Order in Docket No. 20188, 87 FCC 2d 1112, ¶ 26 (1981).

net salvage. To properly forecast these factors, an understanding of the technological, operational, and competitive factors of the regulated industry is essential. "In the depreciation process, current depreciation rates have continually been modified and represcribed over time in light of more refined estimates based on current experience."[25] However, with respect to the cable industry, the Commission has no current experience from which to adopt depreciation rules.

The Commission need only review its experience in setting depreciation rates for the telephone industry to see how difficult and complex such a process is. That history reveals the literal impossibility of establishing depreciation policies in this one proceeding, for the Commission's current depreciation rules for telephone companies are the product of decades of development and constant evolution.

For over 50 years, the Commission each year has reviewed and revised depreciation rates for one-third of the major domestic telephone companies. Typically, the procedure is as follows: (1) a carrier submits a depreciation study to the Common Carrier Bureau; (2) the Bureau independently analyzes the data; (3) the Bureau prepares its own preliminary recommendations and forwards them to the relevant state commission(s); (4) the carrier's filings and the preliminary Bureau proposals are discussed at a conference that includes representatives of the company, the staffs of the state commission(s) and the Bureau

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[25] Id.

(the so-called "three-way meeting"); (5) the Common Carrier Bureau makes its final recommendations at the close of the three-way meeting; (6) the carrier formally files for revised depreciation rates, which may or may not be consistent with the Bureau's recommendations; (7) the Bureau issues a public notice requesting comments on specific changes in depreciation rates; and (8) the Commission, on the basis of the record, prescribes depreciation rates.[26] The length of time it takes for the Commission to complete this process illustrates the complexity involved in setting depreciation rates for a telecommunications industry.

While this process may arguably work for the telephone industry, it is inappropriate for the cable industry. First, unlike the telephone industry, the Commission has little experience or familiarity with cable system operations, technology, accounting practices, etc. Without such information, the Commission has limited facts with which to prescribe depreciation rules and schedules for the cable industry.

Second, the arduous process for telephone company depreciation applies only to the major companies. The Commission only prescribes rates and requires the submission of depreciation reports for dominant telephone companies that have operating revenues in excess of $100 million. 47 C.F.R. § 43.43. For the remaining thousand-plus telephone companies, the Commission does not prescribe depreciation rates. Given that the Commission does

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[26] Represcription Order, 6 FCC Rcd 750 (1991).

not prescribe depreciation rates for most telephone companies, it should not prescribe depreciation rates for the cable industry.

Unlike the pre-divestiture Bell System and post-divestiture AT&T and the BOCs, the cable industry is far more heterogeneous.[27] As the Commission recognized in the Notice,[28] depreciation practices vary widely across the cable industry. This suggests not only that a transition to depreciation prescription would be required, but more importantly, that an industry-wide depreciation rate would in fact be inappropriate.[29] Moreover, the procedures employed by the Commission to prescribe, review, and revise depreciation rates for telephone companies will not work here because of the large number of cable systems.[30] Because of the differences in technology deployed to provide service across cable systems, it would be impossible to

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[27] See Supplemental Notice of Proposed Rulemaking, CC Docket No. 84-800, FCC 85-458, 50 Fed. Reg. 33786, 33790 (August 21, 1985) (noting the similarity in capital structures, operating assets, and size of the largest telephone companies).

[28] Notice at ¶ 26.

[29] The SEC requires the use of Generally Accepted Accounting Principles (GAAP) in setting depreciation rates, making it unnecessary for the Commission to adopt specific depreciation methodologies.

[30] In reality, the Commission prescribes depreciation rates for approximately 30 telephone companies, even though the rules require the Commission to prescribe such rates for carriers with operating revenues of $100 million or more. 47 C.F.R. § 43.43(a). This is presumably because the Commission lacks the necessary resources and staff to prescribe depreciation rates for all telephone companies that meet this definition. In contrast, there are over 11,000 cable systems.

develop a single depreciation rate or even individual rates for each plant category.

Third, and as noted above, perhaps the most difficult aspect in developing depreciation rates is determining the useful life of the plant, specifically with respect to its economic obsolence. Cable technology is generally changed-out every six or seven years, long before "wear and tear" would require new plant. Recent technical innovations to be deployed in the very near future, such as fiber optics and digital compression, reveal the complexity of the problem of assessing the useful life of existing cable plant.[31] By adopting excessively long useful lives for rate-making purposes, the Commission risks substantially slowing the rate of technological progress in the cable industry.[32] Consideration of these technological advancements are part of a cable company's depreciation practices and play a critical role in the industry's ability to upgrade and deploy state-of-the-art technology.

Finally, the Commission cannot establish depreciation rates without undertaking a comprehensive analysis of the industry's investment practices. The Commission cannot prescribe

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[31] Plainly, this problem exists in telephone regulation as well. See Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers, 2 FCC Rcd 6473 (1987) ("Because of the multitude of factors which affect the service life of an asset, it is very difficult to forecast accurate service lives, especially for new assets"). Id. at 6474.

[32] See Besen and Woodbury at 5-6, 27-28. The Commission explicitly recognized in the Rate Order "that the technology for cable equipment is rapidly changing and Congress did not intend to inhibit innovation." Rate Order at n. 671.

either a single depreciation rate or individual rates for cable systems without commencing such a study.

Since the Supreme Court's decision in Louisiana Public Service Commission v. FCC, 476 U.S. 355 (1986), which barred federal preemption of state regulation of depreciation for intrastate property, state and federal regulators have disagreed on the appropriate depreciation rates and schedules for telephone companies. That these regulatory bodies disagree over how to set depreciation rates proves that there is substantial uncertainty in the process. To invite this uncertainty into cable, and indeed to add to it by merely guessing to satisfy an administrative expedient would be pure whim. Until such time that the Commission gains experience with and full understanding of the cable industry's operations, technology, and accounting practices, TCI urges the Commission to refrain from establishing depreciation rates and instead review the soundness of individual depreciation practices of those cable companies that have elected cost-of-service showings.

III. THE COMMISSION SHOULD NOT ATTEMPT TO ESTABLISH INFLEXIBLE RULES GOVERNING THE INCLUSION OF OPERATING EXPENSES

The three principal issues raised in the Notice with respect to expenses are: (1) operating expenses; (2) depreciation; and (3) taxes. Because depreciation expenses have been discussed above, this section addresses the remaining two categories. TCI also urges the Commission to give special treatment to programming expenses to minimize disincentives that would otherwise result from the application of rate-of-return regulation.

A. The Commission's Rules Should Permit Cable Operators to Justify the Inclusion of Related Expenses.

The Notice proposes to allow a broad range of items as operating expenses, apparently more by way of example than general description. In general, the Notice seeks to allow recovery of all "reasonable costs." The flexibility this affords to operators to include all legitimate expense items is appropriate. There is no particular basis upon which the Commission could at this stage articulate all categories of expenses incurred in the provision of regulated services, and the Commission should make explicit that its omission of certain other categories of expense, e.g., pole attachment fees, employee training, is not intended to foreclose recovery. Disallowance of certain expenses, if unreasonable or unrelated to providing regulated services, can be made along with the associated tax attributes, where appropriate, in particular cases.

Expenses that are unrelated to regulated services are proposed to be excluded, and common costs are to be allocated in accordance with the rules set forth in Section 76.924(f) and (g) of the Commission's rules.[33] TCI believes that the Commission

[33] These rules provide for direct assignment of costs, where possible, based upon the "origin" of the costs, cost-causative linkage with directly assignable costs, and finally, allocation proportionate to the assignment of direct costs.

cannot be any more specific in its ratemaking at this stage, as more fully discussed in Section V.

1. Programming costs should be expensed with a mark-up.

The Notice proposes to treat programming costs as any other operating expense, to be recovered without any additional return. Notice at n. 24. This proposal flows from a fundamental misunderstanding of how the cable business works. Programmer/suppliers to the cable industry do not by any means stand in the shoes of all other suppliers of inputs used to provide cable service to the public; to treat them as if they were analogous to the electric utility providing the necessary power to operate the system -- whose prices and liabilities are wholly independent of the risk of retailing cable service -- is a crucial mistake.

The relationship between cable operators and their programmers is far more accurately portrayed as a joint venture to provide cable programming to the viewing public, and "characterized as one of a common interest." Besen and Woodbury at 29. It is not conceptually a mere contractual relationship.[34] Because the combined revenues of cable programmers and operators increase or decrease based upon their joint efforts in creating and promoting programming, they share risk like other co-

[34] The Commission has recognized the joint venture-nature of broadcast networks and their affiliates. See Network Inquiry Special Staff, An Analysis of the Network-Affiliate Relationship in Television (Oct. 1979). The same relationship obtains with respect to cable programming networks and their distributors.

venturers or partners. This risk sharing is effected primarily through the per-subscriber fees paid by operators to programmers. The value of this consideration will vary widely depending upon both consumer acceptance of the particular cable programming service and consumer acceptance of cable service in general. The success or failure of one party is ultimately shared by the other: the hallmark of a joint venture.

Moreover, the success or failure of the programming service and the system that carries it are interdependent. A cable system that carries popular or innovative programming will be able to achieve and sustain good penetration rates; similarly, programming services benefit from the promotions and sound operations by the systems on which they are carried. Together, cable programmers and cable operators offer programming to the public, and together they succeed or not in attracting viewers. The greater the value consumers place upon the availability of a particular programming service, the more valuable the cable system becomes. Conversely, the carriage of an unpopular service translates into decreased customer acceptance of the entire set of cable services, and lost opportunity costs in failing to carry a service that subscribers do want.

Regulation must account for the risk to the cable operator in contracting for programming, which is an element of the operator's costs. This risk, as Drs. Besen and Woodbury explain, arises when a cable operator pays a higher price initially for all program services, and thus incurs a loss, in return for a lower price in the future for those services that are successful. Besen and Woodbury at 29-31. Failure to take into account the initial losses in a cost-of-service proceeding has the direct effect of disallowing recovery of the true costs incurred by the cable system. Without being able to recover the costs of bearing these risks, cable operators will have a disincentive to undertake such risks in the first place. New programming, and the continued carriage of marginal programming (such as niche programming targeted at select population segments, including minority programming), will suffer because cable operators will be discouraged from carrying programming that entails greater risk. The societal costs of this are not only economic ones; they threaten severe cultural costs as well.[35]

It is well accepted in economic learning that cost-of-service regulation can create perverse incentives to overinvest in expenditures permitted in the ratebase. See Averch & Johnson, Behavior of the Firm under Regulatory Constraint, 52 Am. Econ. Rev. 1052-1069 (1962); Wellisz, Regulation of Natural Gas Pipeline Companies: An Economic Analysis, 71 J. Pol. Econ. 30-43 (1963). Regulation induces the regulated firm to "overuse" items that are included in the ratebase, usually physical capital. For cable companies, the effect of treating programming costs as

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[35] The traditional model of utility ratemaking could account for these risks by including their costs in the ratebase. However, because it is unlikely to do so, the use of a mark-up is justified.

"just another" expense could be to discourage cable companies to invest in programming and instead to invest in plant facilities, reducing the quality of service to subscribers. Besen and Woodbury at 31-32. A rule for programming, in part in recognition of the social and cultural externalities involved, would permit a mark-up on programming expenses in order to counteract these perverse incentives. See id.

2. Taxes are appropriate expenses regardless of the ownership structure of the cable system.

The Notice proposes to include all taxes as part of an operator's recoverable expenses. TCI agrees with the recovery of income taxes based on the expected taxable income and the current statutory tax rates for the specific system under review irrespective of the ownership form using full interperiod tax allocation on a stand-alone basis. The Commission's proposed departure from this general rule for cable systems operated by Subchapter S corporations and partnerships is unlawful.

While it is rare for public utilities to take the form of partnerships or Subchapter S corporations, the courts have allowed expense recovery of imputed taxes for such utilities. See, e.g., Suburban Utility Corp. v. Public Utilities Com., 652 S.W. 2d 358 (Tex. 1983); Greely Gas Co. v. State Corp. Com., 807 P.2d 167 (Kan. App. 1991).

In the cable industry, it is quite common for cable systems to be operated as either partnerships or Subchapter S corporations. TCI in fact holds interests in numerous cable systems by way of partnership interests. Any income derived from these interests are fully included in TCI's corporate income tax liability, subject to corporate income tax rates.

Income taxes are plainly part of the reasonable expenses of operating the systems. The proposal in the Notice to exclude such taxes appears to be based on a simple misunderstanding of how such tax liabilities are generally treated, and thus TCI respectfully requests that the FCC allow such taxes to be included in cost-of-service showings.

IV. THE COMMISSION MUST ADOPT RATES-OF-RETURN ON CASE-BY-CASE DETERMINATIONS

The Commission proposes to adopt a single rate-of-return for the provision of regulated cable services by all cable operators for the purpose of setting rates based on a cost-of-service showing.[36] To do so, the Commission proposes to use the S&P 400's cost-of-capital as a surrogate for determining the rate-of-return for regulated cable service.[37] TCI opposes the Commission's proposal to adopt a rate-of-return for the cable industry.

TCI is concerned that a unitary rate-of-return cannot adequately reflect the actual cost elements for all cable operators. TCI, for example, is currently rated as investment grade securities by all accredited rating agencies, a situation not widely common among other cable operators.[38] Further, TCI's

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[36] Notice at ¶ 46.

[37] Id. at ¶ 50.

[38] Tele-Communications, Inc. Annual Report for 1992 at 5.

capital structure is vastly different from several of the other operators that are public companies. For these reasons, the Commission must afford each cable operator the opportunity to support its own specific costs and capital structure as part of a cost-of-service proceeding.

While conceding that "a determination of separate rates-of-return for each franchise area or company would permit the most accurate balancing of subscriber and operator interests,"[39] the Commission tentatively concludes that it will adopt a unitary rate-of-return for the cable industry. The Commission justifies its position by asserting: 1) the reliability of separate rates-of-return is outweighed by the increased burden on local franchise authorities, cable operators, and the Commission;[40] and 2) the factors on which a rate-of-return is based are not likely to be so different that it is necessary to establish individual rates-of-return.[41] Neither of these rationales supplies the necessary justification for the Notice's approach.

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[39] Notice at ¶ 46.

[40] Id. at ¶¶ 47-48.

[41] Id. at ¶ 49. The Commission relies on a third rationale, that there are no well accepted and readily calculable methods for isolating the business and financial risks associated with an individual franchise. But the fact that the task may be difficult does not mean that it can be avoided.

A. Administrative Efficiency Dictates Against a Unitary Rate-of-Return Determination.

The Commission's proposal to discern an industry-wide cost-of-capital is ostensibly based upon its experience with telephone company regulation. For several reasons, discussed below, the analogy does not hold.

In promulgating rate regulations for the local exchange industry, the Commission is fulfilling its obligation under the Communications Act through the mechanisms established in Title II of the Act. In direct contrast, with respect to cable rates the Commission is seeking to establish a framework to serve exclusively as a secondary means of regulating rates. Administrative expediency may serve as a rationale for regulating an entire industry where indeed the FCC has been instructed to regulate the entire industry on that basis, and where the alternative is to develop 1100 individual company costs for companies which are not that disparate to begin with. It cannot serve, however, as a reason for "shortcuts" where the FCC is explicitly forbidden to regulate the entire cable industry on a rate-of-return basis, and where the Commission is proposing to regulate only by exception. Because the application of the rate-of-return model in the context of cable is intended to be used only for a limited number of companies, superimposing a permitted rate-of-return for the industry as a whole threatens to produce all of the inefficient effects, well-documented for this form of regulation -- the very result that Congress desired to avoid from the beginning.

Importantly, an industry-wide average is not in any event what is needed for cable rate-of-return regulation. The "backstop" function of rate-of-return regulation of cable companies means that an industry-wide rate-of-return for the cable industry (if there were such a thing) is not what is relevant. Rather, the use of cost-of-service hearings is intended to be used by the outliers, those cable companies whose costs exceed the average. Thus, in searching for the "correct" cost-of-capital, the Commission theoretically needs to find the cost-of-capital for that specific set of companies, that is, a rate-of-return that reflects the costs of the company seeking the backstop feature. An industry-wide average by definition fails to achieve this. Stated otherwise, it cannot fulfill its necessary "backstop" function.

In practice, however, using a "higher than average" cost-of-capital, if derived on a general basis, could have severely adverse policy implications. It could artificially induce "average" companies to file cost-of-service showings in order to exploit the application of the "higher than average" cost-of-capital to them. Given this unintended result, the FCC has little choice to proceed on a case-by-case basis to assess the individual company's rate-of-return. Establishing a rate-of-return would not aid in streamlining the FCC's enforcement of the 1992 Act, but could actually invite more cost-of-service elections, and incur even greater costs, than a case-by-case approach.

B. Industry-wide Averaging Cannot Be Sustained.

The second rationale of the proposal, that averaging appears to be warranted, is made without any record basis whatsoever. In fact, cable companies can be expected to vary widely one to another with respect to their costs of capital. Cable companies have tended to have very different capital structures, with markedly varying mixes of debt and equity. Cable operators also face differing penetration rates, churn rates and collection rates that result in very different risk levels. Similarly, even under the legislative definitions of competition, cable companies confront disparate levels of "competitive" pressures and thus risk. Further, some cable systems are financed on a local "project" basis; others may rely to varying degrees on corporate-wide means of raising capital.

In this critical regard, the Commission's industry-wide rate-of-return prescription for local telephone companies[42] is thoroughly irrelevant. In its initial rate-of-return prescription for the Local Exchange Carrier's ("LECs") interstate services in CC Docket No. 84-800,[43] the Commission decided that the most important justification for a unitary rate-of-return for the LECs was the Commission's finding that the LECs are part of a

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[42] See, e.g., Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, Phase III, FCC 86-354, 51 Fed. Reg. 32920 (September 17, 1986).

[43] See Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Phase II, FCC 85-645, 59 Rad. Reg. 2d 651 (1986); Phase III, FCC 86-354, 51 Fed. Reg. 32920 (1986).

homogenous industry and face very similar risks in providing interstate service.[44] Concerning the homogeneity of the LECs, the Commission determined:

> The largest exchange carriers which together provide 80% of the nation's access lines, the RBOCs, were purposely set up as seven companies that are quite similar.... [t]he RBOCs were divested with similar capital structures, have similar operating assets, and are all about the same size. Their credit ratings are similar. They share the same regulatory environment, and their management share a common heritage.[45]

The Commission would be hard pressed to make any of these same findings for the cable industry. Cable operators were not "set up" to be similar, instead firms in the industry for the most part arose independently across the country according to unique franchise agreements. Moreover, many cable operations started out, and remain today, as sole proprietorships. Cable operators do not necessarily have similar capital structures, or operating assets, are not close to being the same size, do not have the same credit ratings, and do not share a common management heritage.

The Commission also reasoned that the single service to be regulated, interstate exchange access, was homogeneous across local telephone companies:

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[44] See Supplemental Notice of Proposed Rulemaking, CC Docket No. 84-800, FCC 85-458, 50 Fed. Reg. 33786, 33790 (1985); see also, Phase II, FCC 85-645, 59 Rad. Reg. 2d 651, 654-55 (1986).

[45] Supplemental Notice of Proposed Rulemaking, CC Docket No. 84-800, FCC 85-458, 50 Fed. Reg. 33786, 33790 (1985).

> All exchange carriers' interstate service is subject to the same regulator and is sold to the same interexchange carrier customers through a similar system of access charges. For non-traffic sensitive interstate plant, there continues to be a pooling and sharing of risks among all exchange carriers through the NECA. Moreover, interstate exchange service is not an independent service. Rather, it is useful only when provided as a necessary component of interstate toll service....[46]

As discussed earlier, the degree of revenue sharing and pooling in the telephone industry permits the FCC to make broad assumptions about their average costs. No comparable history or practice permits the same kinds of determinations for cable. Although the rate regulatory structure is set by one governmental body, it will be implemented at both the local and federal level. Other high cost aspects of cable regulation are purely local, such as PEG requirements. Cable operators do not serve the same

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[46] Id. at 33789. Furthermore, in making this assessment, the Commission in CC Docket No. 84-800 discounted arguments of differences in intrastate regulatory actions, geography, bypass, and varying capital structures because the cost-of-capital the Commission sought to prescribe only included the risks that are incident to each firm's interstate risks:

> We are not attempting to ensure that stockholders of LECs receive a reasonable return on their overall investment, we are attempting to provide LECs with an opportunity to earn a reasonable return from services that this Commission regulates.

Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Companies, Phase II, 59 Rad. Reg. 2d 651, 656 (1985).